

No. 12845.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

THE STUART COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF IN BEHALF OF THE STUART COMPANY, PETITIONER.

A. CALDER MACKAY,
ARTHUR MCGREGOR,
HOWARD W. REYNOLDS,
ADAM Y. BENNION,
RICHARD N. MACKAY,
728 Pacific Mutual Building,
523 West Sixth Street,
Los Angeles 14, California,

F. EDWARD LITTLE,
402 Hollingsworth Building,
606 South Hill Street,
Los Angeles 14, California,

Counsel for Petitioner.

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Introduction.

The ultimate issue in this case is one of allocation. The Tax Court, having found upon substantial evidence and in accordance with the terms of the settlement agreement that a portion of the consideration was for cancellation of a contract and a portion was for purchase of a trade-mark, was required to allocate the consideration upon the basis of relative values. (*Cleveland Allerton Hotel, Inc., v. Commissioner*, 166 F. 2d 805.)

The Commissioner ignores this ultimate issue in connection with his appeal, as he ignored it in the Court below. The evidence he produced below, and his argument in this Court, are directed to the point that there should be no allocation. The Tax Court decided that issue against the Commissioner, and its decision that there should be an allocation is supported by overwhelming evi-

dence. On the basic issue of how much should be allocated to cancellation of the contract and how much should be allocated to the trade-mark, the Commissioner produced no evidence; and the Tax Court was bound to find upon the basis of the uncontradicted evidence presented by the taxpayer that no more than \$20,000.00 was paid for the purchase of the trade-mark and that the balance was paid for cancellation of the agreement. The Tax Court followed the principle of allocation when it found, upon the record including the testimony of Mr. Hanisch, that the stock of The Stuart Company had no value and hence no part of the consideration was allocable to the shares re-transferred by Mr. Lewis [R. 59]. But it committed reversible error in allocating any more than \$20,000.00 to the purchase of the trade-mark, contrary to the uncontradicted evidence of record.

I.

In Re: The Commissioner's Appeal.

The gist of the Commissioner's argument is that The Stuart Company paid nothing to cancel the onerous contract of May 5, 1941, and the entire amount of \$197,700.00 was paid to purchase the trade-mark "The Stuart Formula." But the Tax Court rejected that argument [R. 57-58]:

"The evidence discloses that the petitioner desired to abrogate the contract under which it was bound to buy all the vitamin products which it distributed from Vita-Food because it could obtain similar vitamin concentrates at substantially lower prices from other manufacturers. It therefore entered into negotiations with Vita-Food to effect a settlement of the contract. These negotiations were finally successful * * *."

This finding or determination—that consideration *was* paid for cancellation of the contract—is supported by a wealth of evidence; and hence there is no basis for the Commissioner's appeal, *which is founded upon the sole ground that nothing was paid for cancellation of the contract*. The cases cited by the Commissioner himself, on page 10 of his brief, establish that a determination supported by substantial evidence will not be disturbed on appeal.

a. It is amply supported by the testimony of Mr. Arthur Hanisch, the principal stockholder and officer of The Stuart Company, who testified that the provisions which worked the greatest hardship were the ones that precluded him from purchasing products from other concerns, particularly after he had learned in October 1942 that he could obtain a better product from others at a greatly reduced cost [R. 142-144, 218-219]; that he then for the first time proceeded to find out what his rights were under the contract in all respects, including the ownership of the trade-mark, since that was part of the contract; that he believed litigation was in the offing, because The Vita-Food Corporation had issued a notice of partial termination and he assumed there would be a dispute in the matter; and that the trade-mark was not the point at issue, since his chief interest was to get out from under the onerous contract under which he could not operate [R. 238-241]. When asked if the trade-mark was of insignificant value, Mr. Hanisch testified as follows [R. 259]:

“That is completely true, because at the time we got into this discussion I wanted and Mr. Pelletier, one of our officers, wanted me to throw the trade-mark out the window, operate as The Stuart Com-

pany and call the vitamins Stuart's Vitamins, but I had no freedom under this contract to do it, because I was forced to buy from The Vita-Food Corporation. I could not buy from anybody else. I could have operated without the trade-mark if I could have gotten out from under the contract, but I could not operate with the trade-mark under this contract."

b. The finding or determination is likewise thoroughly supported by the testimony of Mr. Robert H. Dunlap, the attorney for and secretary of The Stuart Company who carried on the negotiations resulting in the settlement agreement. Mr. Dunlap testified that The Vita-Food Corporation insisted that The Stuart Company and Mr. Hanisch could not distribute any products unless they were purchased from Vita-Food [R. 321]; that The Stuart Company was losing money and was extremely anxious to cancel the contract, since the officers were convinced that no money could be made as long as the contract was in effect, "whether it was exclusive or non-exclusive" [R. 326-327]; that his entire effort in the negotiations was to cancel the contract so that the company would obtain freedom to go out and buy a better product at a lesser price; that incidentally and as a very minor matter, in order to completely divorce the parties, he suggested getting a quitclaim to the trade-mark [R. 334-337]; and he was most emphatic and direct in his testimony that he intended to engage in a very bitter law suit in order to destroy the obligation of The Stuart Company to buy only from Vita-Food, if the settlement negotiations had been unsuccessful [R. 359-360, 385-386].

c. The finding or determination is likewise supported by the contemporaneous document written by Mr. Dunlap. He had prepared a complaint for the purpose of

seeking a cancellation of the agreement, which he intended to file in its cause of action for declaratory relief as a cross-complaint in the pending injunction suit [R. 355, 367], and which contained the following allegations [Ex. 16, pp. 23-24]:

“That the defendants (Vita-Food Corporation) contend and allege:

“A. That the corporate defendant has a right to give a qualified notice of termination of the corporate plaintiff’s rights under Exhibit ‘A’ (the agreement dated May 5, 1941) * * *

“D. That the corporate plaintiff (the Stuart Company) is obliged and obligated for a term expiring May 5, 1951, to purchase all of its merchandise from the corporate defendant and from no other source.

“E. That at the expiration of said sixty-day period, Exhibit ‘A’ will continue in force and effect as a non-exclusive sales and distribution agreement.”

d. The finding or determination is likewise supported by the written notice of termination sent by The Vita-Food Corporation to The Stuart Company dated October 8, 1942 [R. 49]:

“* * * your exclusive right to sell under said contract is hereby terminated in accordance with paragraph 6 thereof. * * * In all other respects, the contract remains in full force and effect.”

e. And finally, the finding or determination is supported by the settlement agreement itself. The language and terms of the agreement repel the suggestion that it was merely an agreement for the purchase and sale of a trade-mark. In fact, the total consideration of \$197,-

700.00 was required to be paid by The Stuart Company whether it used the trade-mark or not; and if it did not use the trade-mark, ownership was to vest in Vita-Food Corporation, notwithstanding which the full sum of \$197,700.00 was required to be paid by The Stuart Company. The provisions of the contract are absolutely irreconcilable with the Commissioner's contention that the entire consideration was paid for purchase of the trade-mark.

The only evidence to the contrary is the testimony of Mr. Oscar Wiseman, the vice-president of and attorney for The Vita-Food Corporation. He testified that all the consideration was paid for the purchase of the trade-mark; that none of it was paid for cancellation of the contract; that The Vita-Food Corporation was willing to cancel the contract without the payment of any money by The Stuart Company; and that he had so advised Mr. Hanisch and Mr. Dunlap. [R. 443-444, 448-449.]

Mr. Wiseman's testimony was flatly contradicted by both Mr. Hanisch and Mr. Dunlap. Mr. Hanisch testified that he had no such discussion with Mr. Wiseman [R. 240] and that he had never made an offer to Mr. Wiseman to purchase the trade-mark [R. 633]. And Mr. Dunlap was recalled to the stand and asked whether he had heard Mr. Wiseman's testimony to the effect that the latter had offered to cancel the contract without a monetary consideration, and Mr. Dunlap testified as follows [R. 634]:

"Q. Did he ever offer that to you? A. No, sir, he did not.

Q. Did he ever make that suggestion? A. No, sir, he did not."

In addition, Mr. Wiseman's testimony contained its own contradictions in this and in other respects, as will be shown more in detail in the second part of this brief. Suffice it to say here that Mr. Wiseman's testimony clearly indicates that he knew what he was doing in taking the intermediate step. On page 462 he stated that he had told Mr. Dunlap—

“* * * that we had used an intermediary step, because we didn't want to use any harsher methods than absolutely necessary * * *. The contract fixed certain prices, how the orders were to be placed, and other things. *We felt that pattern could be continued if they wanted to go on a non-exclusive basis.* We did not want to restrict them as to other operations they might have. They could sell anything they wanted to, provided they didn't use our labels or our trade-mark.” (Emphasis added.) And on page 463 he stated:

“* * * It was our intention to cancel it entirely, except, as a preliminary step, we took a milder position.* * *”

Mr. Lewis, the principal stockholder and officer of The Vita-Food Corporation, who testified in behalf of the Commissioner as to why Mr. Wiseman advised the intermediary step, stated as follows [R. 589]:

“A. Mr. Wiseman advised us that to invoke the final termination clause would not have exhausted all of his efforts and dictates and he felt that we should lean over backwards and give them an opportunity to do what there was, because *he felt that during the time they were not exclusive sales representatives and something might come up that might cure the entire matter.*” (Emphasis added.)

The Stuart Company would cease to be the exclusive sales representatives only upon the lapse of the 60 days, or on December 7. So, Mr. Wiseman plainly anticipated that The Stuart Company would continue to be bound by the contract, not as exclusive sales representatives, after that period, and that then something might develop which would cure the matter. Moreover, it should be emphasized that Mr. Wiseman admitted that he intended the contract to mean what it said. [R. 572.]

The Commissioner (p. 13) calls attention to the fact that the injunction suit by The Vita-Food Corporation simply prayed that The Stuart Company be enjoined from selling its products under the trade-mark. But, as Mr. Dunlap explained [R. 354], under the law of California the scope of a Court's decree in an equity proceeding is not limited by the prayer. See *Standard Brands of California v. Bryce, et al.*, 1 Cal. 2d 718, 721; *Zellerbach v. A. Lenberg, et al.*, 99 Cal. 2d 57, 68; *Morgan v. Veatch*, 59 Cal. App. 2d at 692; and *Weber v. Supreme Court*, 26 Cal. 2d at 148. It will be observed that page 5 of the complaint [Ex. 15] quotes paragraph 7 of the agreement to the effect that The Stuart Company shall handle no other products than those manufactured or produced by The Vita-Food Corporation.

The Commissioner's brief (pp. 8 and 14) asserts, without citing any authority, that the contract would not have been enforceable against The Stuart Company after its exclusive license had terminated. The answer to this contention is that Mr. Hanisch believed he was bound by the contract or, at the very best, that bitter litigation would ensue in an attempt to cancel the contract. The important point here is that the taxpayer was willing to pay consideration to cancel the contract by settlement,

rather than go through the expense and adversity of a bitterly contested law suit having for its purpose the cancellation of the contract, as, indeed, the Tax Court found and determined.

The point we make here is that it was the function of the Tax Court to determine from all the evidence whether consideration was paid for cancellation of the contract. It made that determination; and, in the light of the overwhelming weight of credible evidence outlined above, it refused to believe Mr. Wiseman's testimony that nothing was paid for such cancellation. Since that determination is supported by adequate, substantial and convincing evidence, it is binding upon this Court. It follows that the Commissioner's appeal is groundless and must be dismissed.

II.

In Re: The Stuart Company's Appeal.

Having properly concluded that consideration was paid to cancel the onerous contract of May 5, 1941, the remaining problem before the Tax Court was that of allocating the total consideration of \$197,700.00 as between the portion paid to cancel the contract and the portion paid for whatever interest The Vita-Food Corporation had in the trade-mark "The Stuart Formula." Upon settled principles of law, cited in our opening brief at pages 25 and 26, that apportionment must be based upon relative values: what was the value to The Stuart Company of being relieved of the burdens of the contract, under which it was required to pay exorbitant prices for its products, in comparison with the value of the trade-mark at that time?

The Tax Court determined that only \$75,000.00 was paid for cancellation of the contract and that the balance

of \$122,700.00 was paid for the purchase of the trade-mark.

It is this determination which the taxpayer maintains was absolutely and completely without support in the evidence.

a. It certainly is not supported by the testimony of Mr. Hanisch, but is directly contrary to such testimony. The gist of his testimony, summarized above, is that he was dismayed at being bound by a contract still having $8\frac{1}{2}$ years to run, under which he was required to buy products only from Vita-Food at a cost at least 25 cents per bottle higher than he learned he could obtain a better product for elsewhere; that he considered the trade-mark to be in ill-repute and of little value and actually calculated what it would cost to adopt a new trade-mark (at not to exceed \$20,000.00 [R. 179-180]); that the provisions in the settlement agreement regarding the trade-mark were merely incidental to the primary object of obtaining freedom from the contract; and that the consideration agreed to be paid by The Stuart Company, except what it would have cost to adopt a new mark, was paid for cancellation of the contract.

b. It certainly is not supported by, but is contrary to, the testimony of Mr. Dunlap, as is indicated by the foregoing summary of his testimony and many other portions of his testimony which could be quoted.

c. It certainly is not supported by, but is directly contrary to, the testimony of the two disinterested expert

witnesses. Mr. Donald Royce, president of William Staats Company, testified that the trade-mark in his opinion was without value [R. 408-409]. Mr. George Miller, president of Strong Cobb and Company, Inc., a large private formula manufacturer, testified that a trade-mark is relatively unimportant in the field of ethical distribution of products through the recommendations of physicians, which was the type of business conducted by The Stuart Company [R. 297-300].

d. It finds no support in the testimony of Mr. Wiseman. We have shown above that the Tax Court refused to believe Mr. Wiseman's testimony that nothing was paid for cancellation of the agreement and everything was paid for the trade-mark. His testimony certainly does not support the finding that \$122,700.00 was paid for the trade-mark—simply because he did not so testify. With Mr. Wiseman it was a matter of all or nothing—black or white; and his testimony was either true or it was not true. The Tax Court refused to believe it on the basic issue, as discussed hereinabove; and having repudiated it on that issue, his testimony was utterly irrelevant on the questions of apportionment and relative values.

There were very good reasons why the Tax Court refused to believe Mr. Wiseman. His testimony contains so many self-contradictions that it was worthy of no credence. We have already pointed out that Mr. Wiseman testified on one hand that he would have agreed to a gra-

tuitous cancellation of the contract; but, on the other hand the record discloses that it was the same Mr. Wiseman who wrote and signed the notice of Vita-Food dated October 8, 1942, stating specifically that except for its exclusive features the contract was to remain in full force and effect; it was the same Mr. Wiseman who, in his complaint for an injunction against The Stuart Company, copied as a part of the complaint paragraph 7 of the original contract to the effect that The Stuart Company "shall handle no other products than those manufactured or produced" by Vita-Food [see page 5 of Ex. 15]; and it was the same Mr. Wiseman whose testimony shows that he intended the contract to go on after the exclusive license was terminated, as we have shown above.

The settlement agreement [p. 3 of Ex. 12] is very explicit that in the event of the abandonment of the trade-mark it shall vest in and be the property of Vita-Food. Mr. Wiseman testified that this provision was inserted at his insistence.

Now, it must be borne in mind that Mr. Hanisch and Mr. Dunlap had been considering the adoption of a new mark. They had discussed the matter—and, more important, they had discussed it in the presence of Mr. Wiseman. Mr. Wiseman admitted that there had been some discussions by The Stuart Company about abandoning the trade-mark "before that was inserted." [R. 511.] And of course it is obvious that such possibility was the reason why Mr. Wiseman insisted on the provision being inserted in the settlement agreement.

The crucial fact is this: The Stuart Company was still obligated to pay the full \$197,700.00, regardless of whether it used or abandoned the trade-mark.

How utterly unrealistic Mr. Wiseman's testimony was! He would ask the Court to believe that the settlement agreement was in reality nothing but a purchase and sale of the trade-mark for \$197,700.00, while at the same time admitting that the so-called vendee was talking about abandoning the use of the mark—in which event the mark would revert to the vendor without altering in any way the obligation to pay the full purchase price. Such testimony simply cannot be believed—and the Tax Court properly refused to believe it. When confronted with this hiatus, Mr. Wiseman's uncertainty and vacillation added to his lack of credibility. At first he said he "doubted" that Vita-Food could retake the name and also collect the money due under the contract; then he said he "would have to think that over"; then he said that while the promise to pay was unconditional, the contract did not say the remedies were cumulative; and he ended by saying, "I believe you asked for my opinion." [R. 507-508.]

All we ask this Honorable Court to do is read the settlement agreement. This was not a purchase and sale agreement. Payments unconditionally due were not tied in whatever with use or abandonment of the trade-mark. And to assert that abandonment of the mark by The Stuart Company would have eliminated its obligation to pay the whole sums set forth therein is nothing but absurd.

Another factor, equally important, illustrates how unrealistic Mr. Wiseman's testimony was. It was Mr. Wiseman who insisted upon the provisions in the settlement agreement binding not only The Stuart Company but Mr. Hanisch as well—which required Mr. Hanisch to retain his stock control and management of The Stuart Company. Why? Because, according to Mr. Wiseman, if Mr. Hanisch were not thus bound by the agreement, "it wasn't worth two cents"; the agreement by The Stuart Company to pay nearly \$200,000.00 "would have been an entirely worthless promise." [R. 512.]

Even a witness called by the taxpayer itself could not have given better evidence than this admission by Mr. Wiseman that the trade-mark itself was of inconsequential value. A trade-mark is a symbol of good will; and good will or a trade-mark has value as an independent, intangible asset only if it has the capacity by itself to produce earnings. See page 30 of our opening brief. Hence, when Mr. Wiseman insisted that a promise by The Stuart Company, even as full owner of the trade-mark, would be worthless if dissociated from Mr. Hanisch, he inadvertently destroyed the whole basis for his contention that the trade-mark was the important thing. If the promise of The Stuart Company, with sole ownership of the trade-mark, would have been worthless, as Mr. Wiseman insisted, *a fortiori* the trade-mark itself would be worthless.

Furthermore, when he and Mr. Lewis testified that they would not sell the trade-mark for less than \$200,-

000.00, \$300,000.00 or \$350,000.00, they obviously were not testifying that the trade-mark had any such value (as the Commissioner seeks to infer in the footnote on page 11 of his brief).

It is fundamental that taxes must be governed by the real nature and substance of a transaction. A party cannot alter the tax consequences of a transaction merely by calling it a name, if that name does not describe the substance and reality of the transaction. Mr. Wiseman cannot concede in effect that the trademark was without value and then assert that nevertheless nearly \$200,000.00 was paid for it, simply because the recipient may want to treat the money as capital gain. That, we submit, is exactly what Mr. Wiseman attempted to do.

We respectfully believe that this Court cannot escape the conclusion that there was absolutely no evidence to support the Tax Court's determination that The Stuart Company paid \$122,700.00 for the purchase of the trade-mark. The evidence required a finding that \$20,000.00 was the outside amount that was paid for the trade-mark and the balance was paid for cancellation of the contract. We respectfully call the Court's attention to pages 17 to 25 of our opening brief, for a consideration of the very valuable economic benefits The Stuart Company expected to and did derive solely from the cancellation of the agreement and for an analysis of the terms of the settlement agreement. In reply to the Commissioner's second point, we respectfully refer the Court to pages 43-48 of our opening brief.

Conclusion.

In view of the foregoing we respectfully submit that the Commissioner's petition should be dismissed and that the Tax Court's decision should be reversed with instructions to find that all but \$20,000.00 of the sums paid to The Vita-Food Corporation were paid for cancellation of the agreement and hence were deductible by the petitioner.

Dated September 13, 1951.

Respectfully submitted,

A. CALDER MACKAY,
ARTHUR MCGREGOR,
HOWARD W. REYNOLDS,
ADAM Y. BENNION,
RICHARD N. MACKAY,
F. EDWARD LITTLE,

Counsel for Petitioner.